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Mr. Greenspan's Dilemma

> **"In warning the market, or in providing it with information that it ought to have, one must first get the bemused speculators to pay attention, and then time the announcement soon enough to do good but late enough to be credible and heeded. Neither task is easy. In fact, attempting to convince speculators of the errors of their ways through talk is generally futile."**
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> ***Manias, Panics and Crashes***
> **Charles P. Kindleberger, 1978**

Once again, Federal Reserve Chairman Alan Greenspan has felt compelled to speak out against the rising tide of bullish speculation in the U.S. financial markets. Indeed, his latest comments – delivered to no less an august body than the Senate Banking Committee – amounted to a full-fledged, damning critique of Wall Street's current "New Era" euphoria. More to the point, Mr. Greenspan implicitly threatened to back his words with action, hinting that financial exuberance alone could induce the Fed to raise short-term interest rates.

All in all, it was a remarkable performance. Yet perhaps we can be forgiven for expressing a certain skepticism about Mr. Greenspan's true intentions. In short, we suspect he is bluffing.

Certainly, we can only agree with Mr. Greenspan's bearish views. They, are in fact, our own. But having diagnosed the symptoms of the disease, the Fed chairman conspicuously failed to identify its root cause: the persistent, massive imbalance between meager U.S. domestic savings and excessive U.S. credit creation.

This is hardly surprising, given the Fed's rampant easy-money policies. We found it particularly telling that Mr. Greenspan insisted on describing the bubble in overtly Keynesian terms, as a function of the collapse in liquidity preference – or, as the Fed chairman termed it, in the risk premia demanded by investors. Clearly, Mr. Greenspan's intellectual conversion to the cause of classical economics has gone only so far.

Having threatened the markets with a Fed tightening, Mr. Greenspan must hope the speculative horde takes him at his word. We think this is unlikely. True, the markets have reacted with alarm to his latest saber rattling, as they did following his December outburst. Once again, however, the effect should prove short-lived.

We see several reasons to doubt the success of Mr. Greenspan's gambit. First, as we explain in this letter, the U.S. economy is unlikely to provide any justification for a Fed rate hike. The fourth-quarter GDP surge – already revised downward – soon will give way to economic sluggishness, removing any threat of consumer-price inflation. The global environment is equally torpid, as seen by the mounting woes of the Asian Tiger economies. Finally, the intractable problems of Japan's banking system are likely to keep Japanese interest rates at rock-bottom levels through most of 1997. Even more than the Fed, the Bank of Japan now feeds the global financial bubble.

Slowing growth almost certainly will rekindle the mania on Wall Street, despite Mr. Greenspan's attempt at moral suasion. The Fed chairman then will have to decide whether to lapse into a discrete silence, or follow the example of the BoJ, which intentionally pricked Japan's bubble economy with a series of rate hikes in 1989. Either way, the consequences are likely to be extremely unpleasant. For Mr. Greenspan, there simply are no good options.

IN SEARCH OF A LOCOMOTIVE

In recent months, we repeatedly have expressed our dissent from the consensus perception that the world economy is heading toward a synchronized global upswing, one that will bring higher interest rates in at least some countries, and particularly in the United States. Such growth forecasts are predicated on the view that exceptional global monetary looseness eventually will deliver the conventional global economic recovery. Yet even the most optimistic forecasts suggest rather modest growth.

Our dissent begins with the consensus growth projections for Europe. Discarding the unexpected slowdown of the EU economy to 1.5% growth in 1996 as merely a pause, the OECD predicts the European economy will accelerate to 2.4% growth this year. It would surprise us greatly if this rate was achieved. (As a point of reference, we note that 1996's actual growth total ended up slightly more than 1 percentage point below the OECD's autumn 1995 forecast.) Still, even if this growth target is achieved, it will hardly reduced Europe's existing high levels of unemployment and excess capacity, considering the continent's average long-term productivity growth rate of roughly 2% per year.

This renewed upturn in Europe is supposed to be powered by a very easy money, sharply declining long-term interest rates, a continued appreciation of the dollar and rising global demand. Together, these add up to quite a panoply of economic stimuli. But what bothers us, in the first place, is the question of why the European economy has faltered so quickly after little more than two years of recovery. The U.S. economy, by contrast, has been carried forward by relatively strong investment and by heavy consumer borrowing. But in continental Europe, both have failed to come to the rescue. Nor is any improvement in sight. Export growth is the only properly functioning economic motor.

This is our chief caveat concerning growth expectations in Europe. Regarding the alleged efficacy of monetary ease, we can only repeat our often-expressed opinion that the stimulative impact of loose money largely has been inhibited by existing structural maladjustments and rigidities.

Nor do we share the current faith in dollar doping. The effects of currency swings on real economies always has been grossly overrated. Consider how little the 50% hike in the dollar versus the Japanese yen over the past year has done to correct the U.S. trade balance. As for Europe, the share of trade that is dollar-related is far too small to impart a significant boost to employment under any circumstances.

Europe's economic problems are overwhelmingly home-made, not dollar-made. The greenback is at most a marginal influence. Capturing foreign sales and economic growth simply through currency devaluation has never succeeded. But of course, a weak dollar has become the traditional scapegoat for Europe's politicians, who are deplorably unable to cope with the economic problems of their own countries.

Japan's economy, meanwhile, is likely to slow sharply in the middle part of this year under the impact of drastic fiscal tightening. But the heavy fiscal drag on domestic demand – now expected to be more than 2% of GDP – will be more than offset by modest gains in investment, consumption and net exports. Importantly, a transition towards stronger export growth does appear to be on its way. While Japan's financial woes continue, an export-driven recovery at long last is in the cards. Weakness in the Tokyo stock market is the main near-term concern. The net effect is to leave the Bank of Japan very little choice but to keep the money spigot wide open, despite the economic recovery.

While the sluggish outlook for Europe and Japan in 1997 is pretty clear, we see two major imponderables. One is the U.S. economy; the other the emerging economies of the Far East.

ANATOMY OF A PHONY GROWTH SPURT

As to the U.S. economy, its 3.9% spurt in the fourth quarter by no means has changed our expectation of an impending slowdown brought on by consumer retrenchment and weaker business investment. As already spelled out in our last letter, the illusion of a sharp rebound last quarter was created by a collection of statistical distortions, grossly magnified by the American habit of annualizing these data.

Last quarter's growth surge was powered largely by exports, which rose $46.4 billion, or 24.8%. This gain accounted for no less than 2.7 percentage points, or 70%, of total reported real GDP growth. These figures are simply bizarre, in particular when viewed against the backdrop of anemic economic growth in the rest of the world and the long-run deterioration in the U.S. trade balance. They immediately suggest a statistical quirk and cry out for a closer look.

In our last letter, before the detailed data were available, we warned that U.S. export performance was due for a statistical fluke. As we pointed out, there is an established pattern of U.S. trade flip-flops in the second half of the year, apparently due to faulty seasonal adjustments that are grossly magnified by the regular annualization of the data. In third quarter 1996, by contrast, the net effect of stagnating exports and surging imports reduced GDP growth by 1.3 percentage points.

The first thing to see is that U.S. two-way quarterly trade flows actually amount to a sizable $450 billion. What enters into the GDP calculations is the net balance of exports and imports. In recent years, this quarterly net balance has run at a relatively paltry $20-30 billion, representing the excess of U.S. imports over exports.

Now comes the truly ludicrous part of the tale. Random swings in these huge trade flows translate into big GDP effects. What happened in the fourth quarter was that the U.S. balance of trade in goods and services improved by $9.4 billion, an insignificant change in relation to total trade flows. But annualized, it became $37.4 billion, accounting for 57% of total GDP growth of $66 billion.

As a matter of fact, the Commerce Department officially reported that the positive trade data for October and November were heavily influenced by just two events: a bulge in plane deliveries by Boeing and the Ford Motor strike in Canada. Such are the extraordinary events that have been annualized into a production boom.

One statistical quirk inevitably begets the next one. On February 12, the American press reported the sharpest jump in U.S. productivity in four years, as nonfarm business productivity rose at a 2.2% annual rate in the fourth quarter. We quote the following example of the euphoric coverage: "Rising productivity is the key to better growth and lower prices since it means businesses can produce more goods or services with the same number of workers. That should allow businesses to make higher profits while keeping prices charged to customers in check."

Or, to quote a more typical conclusion in the markets: "Basically, much of the strong growth recorded in the fourth quarter was generated by productivity gains. Hence a complete lack of inflation pressure and prospects of high profits." The reality, of course, is that this boost to productivity essentially reflected the same annualized statistical quirk as the underlying strong GDP growth.

The bottom line is that the U.S. economy's growth spurt in the fourth quarter was, indeed, largely a statistical freak. In fact, the growth of gross domestic purchases declined to 1.7%, from 3.3% in the third quarter, both at annualized rates. Another dubious major contributor to fourth-quarter GDP strength was a surge in nonresidential construction. Helped by favorable weather, this reportedly rose an impossible 25.2%. All in all, there was much more weakness than strength in the fourth-quarter numbers. In this light, the decline of the price deflator to a 1.4% annualized rate of increase – a new low – makes good sense.

FAR EASTERN TRADE SHOCK

So much for the U.S. economic situation. For some time now, we have been paying particular attention to economic and financial developments in another part of the world, developments which also may have serious implications for the world economy, the dollar and the global financial markets. We refer to the so-called Tiger countries of the Far East. We have marked them out for special attention for four reasons:

- In the 1990s, developing Asia has become the dynamo of world economic growth and world trade, with annual economic growth rates of 8-10%, and exports and imports expanding at annual rates of between 20-30%.

- The central banks of the Tiger countries in recent years have accumulated hundreds of billions of dollars in foreign-exchange reserves, which they overwhelmingly have invested in U.S. Treasuries. Thus, they have become crucial players in the international central-bank cartel that is propping up both the dollar and the U.S. bond market.

- Collectively, the Tigers countries now play a decisive role in global output and trade in electronics. What happens to these industries will reverberate through out the world – and world stock markets.

- The most crucial point stems from the first three. The above statements reflect the excellent developments in these economies over the past three or four years. But in 1996, the situation changed drastically. Plunging prices and slowing demand ravaged their electronics exports. After several years of high double-digit export and import growth, both have collapsed virtually to zero.

One question now is key: Is this trade setback just a cyclical, inventory-related pause that will refresh, or a does it mark the onset of a longer-term over-investment crisis centered on excessive expansion of electronics manufacturing capacity? Which is it? If the latter, it would mean severe trouble not only for the region but for the world economy and the global financial system as well.

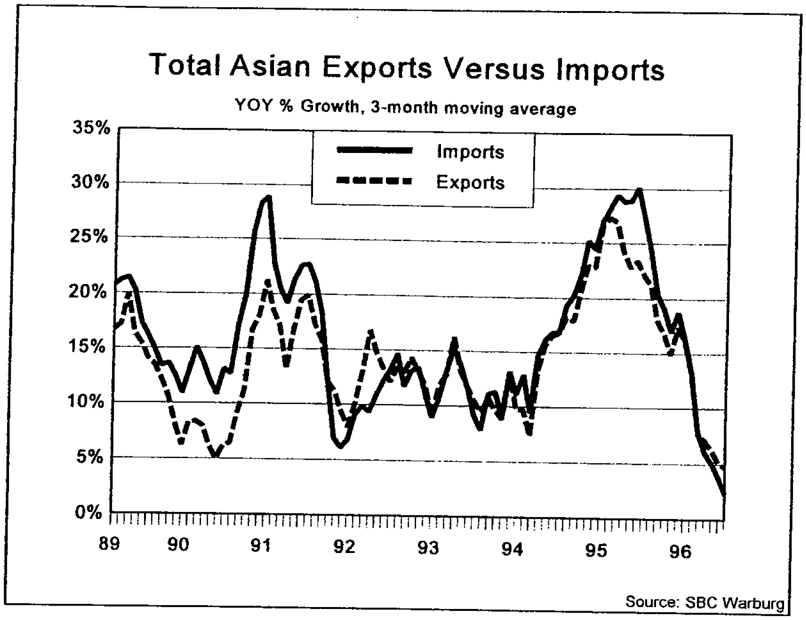
The conventional, comforting argument is that nothing serious can happen to these countries because – aside from their current-account deficits – the Tiger economic fundamentals are the best in the world, far superior to the older industrialized nations. Indeed, the common, outstanding structural features of the developing Asia economies are their outsized savings and investment ratios of 25-30%, or even higher.

It sounds plausible. But to us it calls to mind another country, one with even better fundamentals in the form of equally stellar savings and investment ratios, a huge, chronic trade surplus and the lowest consumer and producer inflation rates in the world. We refer, of course, to Japan, the world's largest creditor nation.

To be sure, the growth performance of the Asian Tigers in the 1990s has been breathtaking. In the traditional view, the industrial nations lead world economic growth, with the developing countries following in their wake. But in recent years, the Tiger economies have forged ahead while the advanced countries have remained mired in sluggish growth or near-recession.

As a result, trade flows have shifted dramatically. Overall, the trade balance of the developing nations with the industrialized world has swung from a modest surplus in the late 1980s to a record deficit of some $142 billion currently. But while a record, this trade deficit has been dwarfed by the capital and money inflows into the same countries, now running at around $250 billion a year. This has fueled an unprecedented accumulation of foreign-exchange reserves by the Tiger nations.

A recent study by the International Monetary Fund notes that a "significant structural break" has occurred in the economic relationship between the developed and developing worlds. Instead of mirroring the slowdown in the industrial nations, growth in the developing countries – particularly in Asia – has sharply accelerated. This boom, and the surging imports associated with it, substantially helped limit the recessions of the early 1990s in the industrialized nations, and contributed greatly to their subsequent recoveries.



Since 1990s, developing Asia's share of total world imports has jumped from 13% to over 20%. Lately, the region has accounted for 20% of U.S. merchandise exports, and over 40% of Japan's exports. We assume a sizable part of these flows reflect the surge in U.S. and Japanese direct investment in the Tiger countries.

If one group of countries enlarges its trade share, other participants by definition must be losing ground. These others, in fact, are the industrialized nations. Their share of world imports has plunged to 68.2%, from 75.2% in 1990, while their fraction of world exports has dropped to 69.7%, from 73.3%. America's share of global imports, by the way, has been stagnating at around 15%, while its share of global exports also has remained constant, at around 11.5%. The main loser – more in imports than in exports – has been Europe.

These facts thoroughly debunk the myth of exploding global trade. What has boosted total trade during the last few years overwhelmingly has been surging intra-regional trade flows among the booming nations of developing Asia. In other words, the supposed big global trade spurt was regional, not global.

THE WOES OF THE TIGERS

Basically, the woes of developing Asia are of the Japanese variety, both in their causes and in their effects. To prevent huge capital inflows from appreciating their currencies and hurting their export competitiveness, the central banks of the Tiger countries have been accumulating foreign-currency reserves at a furious pace. Because of the scale of these purchases, and the relative primitiveness of the Tiger money markets, these reserves in effect cannot be sterilized. The essential outcome has been runaway money and credit growth amidst low real interest rates, leading to a long list of symptoms associated with overheating economies – inflation, financial speculation, and excessive investment in industrial plant and property.

The resulting excess domestic demand has driven the Tiger economies into trade deficits – despite their high savings ratios. During the 1990s, the foreign-exchange reserves of these countries have rocketed from $150 billion to $450 billion. This dwarfs even Japan's own enormous dollar hoard, now totalling about $215 billion.

Considering their high savings and investment ratios, these countries greatly resemble Japan. But looking at their balances of payment, the striking similarity is with Mexico. While Japan's reserve accumulation accrued primarily from its burgeoning trade and current-account surpluses, the dollar glut in the Tiger countries arises completely from money and capital inflows that have vastly exceeded their trade and current-account deficits, thereby leading to massive foreign-exchange reserve growth. Only Singapore and Taiwan are in current surplus.

The magnitude of the problem is indicated by the size of the current-account deficits now being recorded by the Tiger countries. For 1996 and 1997, we can offer only estimates and forecasts, ones that well may prove too optimistic. Korea, for example, recently announced a deficit of $24 billion, or 4.7% of GDP, in 1996, compared to an earlier IMF estimate of 3.1% of GDP.

Asian Current Account Balances
As % of GDP

	1995	1996	1997	Inflation Rate
China	0.2%	-1.2%	-1.5%	6.6%
Indonesia	-3.7%	-3.6%	-3.7%	5.5%
Korea	-2.0%	-4.7%	-2.5%	4.7%
Malaysia	-8.2%	-8.2%	-6.9%	3.3%
Philippines	-2.6%	-3.1%	-3.1%	5.0%
Thailand	-8.1%	-7.9%	-7.5%	4.3%
Singapore	17.7%	15.5%	13.9%	2.0%

Source: International Monetary Fund

It often is rightly stressed as a further great positive for the Tiger countries that their capital inflows substantially represent foreign direct investment. However, these flows are heavily centered in China, Malaysia and Singapore. Otherwise, the greater part of the capital pouring into developing Asia consists of financial flows, attracted both by the robust economic fundamentals and the high yields on financial assets available in the region.

FINANCIAL EXCESS AND CURRENCY MISMATCH

An aggravating and complicating factor is the fact that in several Tiger countries, both banks and highly geared corporations have incurred large, unhedged liabilities in foreign currencies, chiefly the dollar, because of the substantially lower interest rates available in those currencies, relative to domestic borrowing. Given the widespread pegging of the Tiger currencies to the U.S. currency, dollar borrowing obviously is preferred.

The ultimate result: While the Tiger central banks furiously accumulate reserves in order to cap their currencies, Tiger commercial banks just as furiously borrow dollars and yen to fund their domestic runaway credit growth, thus defeating the purposes of the central banks.

Further evidence of overheating can be seen in the region's producer- and consumer-inflation rates. Everywhere except Singapore they exceed 4%, and in some countries, such as Indonesia, they now are nearing 6%. With most Tiger exchange rates quasi-fixed to the dollar, this actually implies their real, inflation-adjusted exchange rates are appreciating against the dollar, and still faster against the European currencies. Overall, wages also are rising faster than productivity. In addition, the yen's collapse against the dollar is causing tremendous competitive strain.

We wouldn't say this is altogether a comforting development. It implies a massive currency mismatch on the balance sheets of the region's banks and corporations, and a tremendous vulnerability of the Tigers' financial systems to a reversal in capital flows. Taking advantage of the favorable spreads between lower dollar rates and higher domestic rates requires the region's dollar borrowers to leave those liabilities unhedged. Since dollars and yen are so abundantly available, central banks have virtually no control over the credit machine.

Evidently, the financial systems of some of these countries are in extremely precarious balance. Overall, the Tigers' huge hoard of foreign-currency reserves would seem to offer ample protection against external disturbance. But almost 80% of those reserves belong to China, Hong Kong, Singapore and Taiwan. The other Tiger countries would quickly run into severe currency and liquidity crunches if capital flows were to reverse.

Rampant, precariously funded credit creation is only one of the big problems facing the Tiger economies. A second one, essentially correlated with the first, is the growing misallocation of this rapid credit growth. Again, it often is positively stressed that most of this credit has financed booming investment rather than government

spending and private consumption, as in the industrialized nations. Unfortunately, prolonged overinvestment jeopardizes economic stability no less than prolonged overconsumption – as Japan's dramatic bubble demonstrated.

In the Tigers, as in Japan during the late 1980s, vast sums have been channeled into overexpanding property sectors, into financial speculation, private consumption, money-losing state enterprises and politically well-connected corporate deadbeats. In a number of Asian countries, nonperforming loans now abound. Little wonder that investors have been dumping Asian bank shares with a vengeance.

THE MAJOR RISKS

The main, immediate concern for developing Asia is the unfolding trade shock stemming from the retrenchment in the global electronics industries. But for the time being, any serious worries have been shelved with the comforting thought that this setback is overwhelmingly a short-term inventory correction. Strongly rebounding global growth, it is thought, soon will make short work of the slump. In this respect, all eyes in the region are focused hopefully on the U.S. economy and in particular on the U.S. consumer. Unfortunately, the flip side of this optimism is a general refusal of the region's manufacturers to reign in production and capacity additions.

Electronics Products As % of Total Exports

1995 Data	
Singapore	66%
Malaysia	52%
Philippines	41%
Taiwan	36%
Thailand	24%
South Korea	17%
Hong Kong	16%

Meanwhile, the bill for overexpansive credit is coming due. If the region's banking problems are allowed to fester, its banks could become trapped, with bad loans crimping their capital bases, forcing a painful contraction of credit. Given the heavy dependence of many Tiger financial systems on "hot money" inflows from abroad, this could trigger tremendous currency turmoil. The resulting credit crunch could push some countries into recession, aggravating the bad-loan problem and worsening the squeeze on the banks.

If this scenario seems improbable, given the Tigers' growth history, the same was said of Japan in the 1980s. Like Japan, the Tigers have created a economic juggernaut that can survive only by moving forward. Only rapid growth can justify the massive investments that have been made in industrial capacity and sustain the credit pyramid that has financed those investments. Slower growth threatens a catastrophic unwinding of the region's excesses.

In short, the awesome growth performance of the Tiger countries over the past ten years should not blind us to the enormous problems that have been accumulating. These problems have been aggravated by the credit excess of the industrialized countries. Basically, the Tigers as a group generate enough domestic savings to finance their high investment ratios. But, because they have allowed their domestic markets unfettered access to global financial capital, they have been inundated with yield-greedy "hot money" from abroad. This has fostered overheating, financial excesses, structural distortions and increasing dependence on those same hot-money flows. It would appear the surest way for a developing country to imbalance its economy and ruin its financial system is to peg its exchange rate and accumulate foreign reserves.

There is one exception: Singapore. While largely sterilizing its heavy currency interventions, the island city state also has allowed its currency to soar 35% against the dollar since 1985. As a result, it has the lowest inflation rate and the strongest balance of payments of any Tiger country, with a current surplus equal to 15% of its GDP.

For the reasons previously explained, our focus is on the woes of the electronics industries. If the weakness in global electronics demand remains prevalent, the risk for the Tiger economies is of a very hard landing.

In this respect, we are struck by the strange juxtaposition of the dramatic electronics slowdown in the Far East and the current technology euphoria on Wall Street and in the global stock markets. Since last July's lows, share prices of most U.S. and European high-tech producers have doubled. Apparently, this bullishness has played a dominant role in propelling the overall gains and increased volatility in the stock markets. It makes for a ludicrous contradiction between industrial doldrums and stock-market euphoria. Yet there is one thing that unites them, and that is hope – the underlying hope that the global electronics slump is just a short-lived inventory correction.

Is this hope well placed? We don't feel competent to forecast U.S. and global demand for computers, but the statistics show a sharp, sustained downtrend in demand growth since late 1995. What seems to have obscured this decline are the super-high growth rates from which it started. In Japan, a continued explosion in demand has been met by booming imports from the United States and the East Asian countries. But even in Japan, demand growth is slowing, from 70% in 1995 to 45% in the whole of 1996, and only a 10% annual rate in 1996's fourth quarter.

In the United States, it has been argued that any temporary satiation of consumer demand will be more than made up for by continued booming demand from commerce and industry. But instead, evidence is building that business buying also is cooling from last year's torrid pace. Not only that, but sharply slower demand growth globally is colliding with an unprecedented rate of growth in computer production capacity.

WALL STREET TECHNOLOGY EUPHORIA VERSUS DISMAL REALITY

Observing the troubles in the electronics industries of the Far East, we cannot help wondering about Wall Street's continued appetite for U.S. technology stocks. Could U.S. computer producers be immune from the sector's gathering woes? Of course not. The paramount questions, then, are the nature and duration of the global slump.

In January, excellent earnings news from Intel, the microprocessor maker, helped rekindle the tech euphoria. Immediately, the news was hailed as a sign of the sector's renewed strength. Conveniently, the market ignored the numerous other disastrous fourth-quarter results. Apple's sales, for example, plunged 34% year-over-year, while Digital Equipment's fell 20% and Acer's 38%. Compaq saw revenue growth fall to 15%, from 45% in fourth quarter 1995. Despite such news, the Nasdaq 100, heavily weighted with technology stocks, gained 12% in January.

While global economies – particularly the struggling Asian Tiger economies – increasingly suffer from overinvestment in tech-related manufacturing capacity amid slumping demand, Wall Street continues to spread unmitigated hype by expounding the inventory turnaround story. The greatest frenzy has been generated by makers of semiconductor fabrication equipment. Since hitting their price lows last July, the sector's leading companies – Applied Materials, Novellus Systems and Lam Research – have gained 195%, 180% and 95%, respectively.

But meanwhile, a growing number of technology stocks has suffered extended and significant declines. With IBM, Intel and Cisco down 25, 18 and 19 points, respectively, from the highs of January, the market's favorites are proving vulnerable. Interestingly, many of last year's successful, aggressive growth mutual funds, which generally were overweighted in technology stocks, are showing losses so far in 1997.

In clear confirmation of our view of prevailing monetary ease, investors have gravitated instead to financial stocks, where the S&P Bank Index and the Amex Security Broker-Dealer Index have posted year-to-date gains of 18% and 21%, respectively. In the market's eyes, easy money can and will feed this roaring bull almost indefinitely.

GERMANY'S BAD START

By any measure, 1997 had gotten off to a bad start for Germany. Most recent news, be it on unemployment, the budget deficit, inflation or business confidence, has been disappointing. In addition, the government's tax- and

pension-reform projects have run into trouble. Among businesses, labor shedding remains the favorite device for boosting profits and share prices. Unemployment rates and profits are hitting record levels simultaneously.

Still, the shocking January jump in unemployment was substantially exaggerated and largely will reverse in coming months as weather conditions improve. Job cuts in construction accounted for much of the surge. While the building sector's weakness is undisputed, seasonal factors have grossly overstated the deterioration, owing to a change in bad-weather payments. The elimination of public subsidies has motivated firms to shed labor in inclement weather, entitling their workers to claim jobless benefits and thus join the ranks of the officially unemployed.

A jump in West German inflation to 1.8% in January from 1.4% in December can be explained partly by a base effect and partly by sizable gains in the prices of heating oil and some seasonal foodstuffs. In any case, the little bit of inflation that still exists in the German economy comes mostly from administrative prices and rents. The key factor behind the low inflation rate is the trend towards wage moderation, with pay checks now rising in line with current productivity growth. Unit labor costs have been flat since 1993. Therefore, the rise in import prices stemming from the decline in the DM has not had a marked impact on the cost of living. But the Bundesbank nevertheless has signaled a warning that the exchange-rate correction should now come to an end.

Though the German economy is emerging from a trough, there are no signs of any vigor in it. The decisive handicap is the failure of the investment cycle to kick in. The building sector still is in outright recession, as substantial tax subsidies for projects in the former East Germany have expired. Unemployment, a sizable rise in social contributions and near-stagnant real wages are keeping a lid on consumption. Under these conditions, any surprise about economic growth will be on the downside. We believe the impetus widely expected from the stronger dollar has been grossly overestimated. The contrary effects of the yen's collapse against the DM largely are ignored.

Over the next 18 months, Germany will face its toughest political choices since unification. Discord about tax and pension reform, and a dispute about how to plug the budget gap are rocking the ruling coalition. As *The Economist* asked in a recent leading article: "Is Kohl in control?" He definitely is not. His reputation is incomparably higher abroad than it is at home. His main appeal to voters is the view that he is the lesser of two evils compared to the Social Democrats' Oskar Lafontaine. It is no longer unthinkable that he will choose to step down rather than face another election. Actually, Mr. Kohl's resignation would strengthen the DM, since it would radically reduce the chances for European Monetary Union. Few Germans would regret either development.

Even if Mr. Kohl survives, the outlook for EMU remains dim. In its recent monthly report, the Bundesbank cast fresh doubts on Germany's ability to meet the Maastricht criteria. The central bank bluntly criticized the slow pace of economic reform, warning that existing structural problems cannot be solved by means of monetary policy.

Yields on German 10-year Bunds have hit 5.5%, the historic bottom of their long-term trading range. This level has held in all previous Bund rallies since World War II. Will it be breached this time? If the world economy proves weaker than expected, as we think, then Bund yields well might fall below it for a sustained period of time. Unusually steep yield curves and unusually low inflation rates, implying very high opportunity costs for holding cash, are extremely supportive for bond markets in the hard core of the existing European Monetary System.

An interesting aspect of the boom in German bonds is that it has been almost completely fueled by domestic banks and foreigners, including numerous tax-shy German investors trading through foreign accounts. In 1996, banks bought no less than 46% of net new issues, while foreign entities, including tax-shy Germans, accounted for 43% of total purchases. Officially, domestic non-banks – private and institutional investors – have been sidelined since October 1995. In 1996, their purchases totalled just 11% of net new bond issues, the second lowest reading after 1993's 5%. As recently as 1995, non-banks were the largest buyers, with a 45% share, compared to 14% for German banks.

This is the typical cyclical pattern in Germany. Once yields fall below 6%, non-bank buyers go on strike and wait for the regular cyclical upturn in yields. Only this time, the business cycle refuses to play along. Persistent economic sluggishness seems likely to force the Bundesbank to maintain its low short-term rates for an indefinite period. With interest rates at 2-3% on short-term deposits, waiting for higher yields is becoming increasingly painful, raising the question of when the liquidity-obsessed German investor will capitulate and rush into longer-term bonds.

Essentially, this obsessive liquidity preference – bearishness towards securities – of German investors has had the intriguing byproduct of producing persistent strong growth of the broad money aggregates. Always bear in mind that bank investing increases bank deposits in the same way as bank lending, but with the important difference that bank investments (to quote the economic historian Joseph Schumpeter) tend to produce idle deposits. In 1996, German banks added roughly DM 110 billion to their bond portfolios, up from DM 28 billion the year before.

THE DOLLAR RUNS AMOK

The speed of the dollar's recent rise against the yen and the DM partly reflects surprisingly strong U.S. economic growth and growing pessimism over the outlook for Japan and Europe. U.S. strength eventually is expected to force the Federal Reserve to raise rates.

Recently, we have read innumerable statements to the effect that the dollar's strength is supported by excellent fundamentals. We ask ourselves: What are these fundamentals? In principal the decisive fundamentals in any market are supply and demand. A rising dollar implies that foreign demand for dollars is outstripping the supply in the global exchange markets. As always, most analysts inherently extrapolate the latest trend. Their simple logic: Because the dollar has risen, it must rise further. The international army of technical chartists relies on this notion.

Just as consistent is our habit of taking a close look at the details of supply and demand. In 1996, America poured about $400 billion into the international exchange markets. Of this sum, about $165 billion came from the deficit in the U.S. current account and about $230 billion from money and capital flows. To put it another way: The United States now must attract more than $1.5 billion in foreign capital each and every business day of the year to balance its external payments. The truth is that the world is being flooded with dollars as never before.

During 1993-96, U.S. current deficits totalled $625 billion and U.S. money and capital outflows about $900 billion. Such vast dollar outflows must be matched by a corresponding amount of foreign investments in dollar assets, either held in the United States or abroad. A rising dollar, clearly, signals that lately these huge dollar inflows have exceeded the outflows. But the snag in this happy fact lies in the *composition* of the dollar inflows.

The core of the dollar bull story is that foreign investors, enraptured by the U.S. economy's superior fundamentals, are buying U.S. stocks and bonds in record amounts. Having repeatedly exposed this story as wishful thinking, we can confine ourselves here to presenting the latest figures. From January to October 1996, total foreign purchases of U.S. stocks amounted to $10.9 billion. True, this was a record, but it was at best a mini-record. Foreign net purchases of Treasuries, by contrast, totaled $169 billion, and purchases of other U.S. bonds about $104 billion.

Of these much larger flows into the U.S. bond market, around $90 billion came from foreign central banks. Roughly another $100 billion came from the so-called "carry trade" – leveraged investments financed with extremely cheap borrowed yen or Swiss francs, chiefly by U.S. hedge funds and other highly speculative entities.

Why dollar strength now? It reflects the cyclical divergence among the G-3 countries. Traditionally, the late stage of the U.S. business cycle, when the Fed is expected or required to tighten, often is associated with further dollar strengthening. In this light, the dollar's strong recovery appears to be a temporary reversal in the currency's long-term downward trend, but this renewed cyclical weakening still is months away.

Basically, we agree with the cyclical perspective. But we disagree with the prevailing view that the U.S. economy is picking up speed, and that this will provoke one or more rate hikes by the Fed. As we explained, the fourth-quarter growth rate of 3.9% was a statistical mirage. In any case, dollar strength is borrowed strength, depending heavily on central banks and the carry trade.

THE PROFITS CONUNDRUM

Despite Wall Street's familiar mantra that traditional stock valuation measures have become obsolete in today's environment, there still is a general, if grudging, agreement that profit growth is critical to stock prices. Thus, recent publications which showed fourth-quarter profits much higher than expected were greeted with glee. As reported recently in the *Wall Street Journal Europe*, the earnings of 690 large U.S. companies soared 61%. Technology companies were credited with a fabulous profits surge of 409%.

The caveat was buried in the text, where it was noted that "earnings a year earlier weren't as strong because of a wave of one-time charges related to companies' continuing restructuring efforts aimed at saving future costs." In other words, the profit comparison was grossly distorted. But brokers and their pet analysts were quick to proclaim these results the beginning of a period of stronger earnings growth, reflecting the jump in GDP growth. Apparently, business profits are important when they rise, but lose any importance when they are weak.

To add to the confusion, it also was reported that the operating earnings of 612 large companies rose just 9.5% year-over-year – and this in the strongest of the four quarters of 1996. Did anyone notice this? Apparently not.

In recent letters, we have warned of widespread profits deception at work, involving the complicity of both corporations and Wall Street. In the current environment, no one wishes to criticize such deceptions as long as they boost stock prices. Corporations dress up profits though stock buybacks and huge "one-time" write offs that improve future profits, while Wall Street manipulates perceptions by measuring reported earnings against estimates that analysts already have deliberately reduced, generally at the behest of the corporations themselves.

A most striking case in point was the recent earnings release from Applied Materials, the world's leading manufacturer of semiconductor equipment. On news that fourth-quarter earnings were four cents "better than expected," the stock shot up 7 points, to 52⅛, inspiring a broad rally in U.S. technology stocks. Conveniently, Wall Street had slashed its earnings estimate – to 44 cents, from $1.05 in June – just in time to produce this earnings "surprise." Overlooked was the fact that everything of importance was drastically down from the previous year, as reported profits fell 48%, revenues declined 20% and new orders tumbled 32%.

CONCLUSIONS

The global rosy scenario remains intact. World economic growth remains subdued, while inflation rates in many countries have declined to lows not seen for thirty years or more. Together, the two are holding off any interest-rate hikes by central banks. This, of course, is the scenario underpinning the buoyancy of global asset markets. We disagree with the view that monetary indicators point to firmer economic conditions down the road.

Does this mean the bull markets are set to continue? It's a possibility that cannot be excluded. But we still think it vital to recognize and understand the monetary and financial excesses behind this global eruption in financial asset values. Financial deregulation and globalization have created virtually unlimited facilities for the creation of money to purchases financial assets in complete independence from available current savings.

By this measure, the global financial boom clearly is a bubble. But, in the absence of any monetary tightening, it is hard to see what will prick it. Certainly, harsh words from Mr. Greenspan are unlikely to do the trick.

For now, Wall Street continues to celebrate the by-now routine achievements of successive record highs. But we find it noteworthy that these advances show declining strength and breadth, while pullbacks are becoming broader and more powerful. The dramatic narrowness of the market's recent advance is demonstrated clearly in the outperformance of the Dow and the S&P 500. Both have posted year-to-date gains of more than 9%, in contrast to the Nasdaq Composite's gain of 4.39% and the small-cap Russell 2000's gain of just 1%.

Meanwhile, yield spreads on corporate bonds and syndicated bank loans have shrunk to the vanishing point, not just in Europe but around the world. "Performance-driven" fixed-income managers have been chasing incrementally higher yields regardless of risk. But this process appears close to its limit, if only because risk premia already have virtually vanished.

Dollar bullishness is rampant again. There is talk of possible or probable overshooting, as in the 1982-85 period, when the dollar soared against a backdrop of a booming U.S. economy versus Eurosclerosis. In our view, this historical comparison is grossly misplaced. Economic growth and interest-rate differentials today are far narrower than they were in the early 1980s. Above all, the Fed then was very tight, while today's Fed is very loose. In the 1980s, tight money meant the soaring U.S. trade deficit was primarily financed through massive banking inflows. This time, overliquid U.S. banks are slashing their foreign liabilities. The dollar's current strength, in short, is driven by speculation, not fundamentals. It will reverse later this year.

Speculation about a delay in EMU once again is a talking point in the foreign-exchange markets. As always, such uncertainty tends to strengthen the DM.

Serious problems for the world economy and its financial system loom in the heavily indebted "miracle economies" of the Far East. Their race to industrialize using cheap labor has led to overbuilding in almost all sectors. The most pressing issue is the regionwide plunge in export growth, stemming from the slump in the global electronics industries.

The main risk factor for currency markets and global bond markets, however, will be the performance of the Japanese economy. The consensus sees nothing but economic weakness and ultra-cheap yen, owing to pending large tax hikes that will hit consumers hardest. But strength has been building rapidly in exports, business investment and residential construction. Unexpected Japanese economic strength late in the year could abruptly cut off the flow of cheap yen that has been fueling the global bubble. The dollar and U.S. bonds are particularly vulnerable.

Notice

Dr. Richebächer will be a guest speaker at a conference of the Committee for Monetary Research and Education, to be held at the Union Club of New York City the evening of Wednesday, April 9. Readers wishing to attend should contact the committee at 10004 Greenwood Court, Charlotte N.C. 28215. Telephone: (704) 598-3717.

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